

LFD GENERAL FUND PRELIMINARY BUDGET OUTLOOK “BIG PICTURE REPORT” 2009 BIENNIUM

A Report Prepared for the
59th Legislature

By
Legislative Fiscal Division

October 4, 2006

Legislative Fiscal Division



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TABLE OF CONTENTS

Table of Contents	i
Introduction	1
Purpose	1
Scope of Report	1
“Model” Approach	1
Table 1 – Statutory Present Law	2
Table 2 - Reserves	2
Table 3 – Potential Impacts Not Included	2
2009 Biennium Budget Projection	3
Projected General Fund Balance	3
Present Law	3
Adjustments Applied to Derive Present Law	4
Revenues	4
Expenditures	5
LFD Recommended Allowances	9
Adequate Ending Fund Balance Reserve	9
Wildfire Suppression Costs	9
Emergency Fund Appropriation	10
Significant Issues Not Included in 2009 Biennium Projections	10
Other Potential 2007 Biennium Cost Over-runs (Supplementals)	10
2009 Biennium Employee Pay Plan	10
Litigation: K-12 Funding Adequacy	10
Litigation: State Fund Lawsuits	11
Litigation: Human Services – MAIDS	12
Litigation: PPL Protested Taxes	12
Long Range Building Program Deficiency (LRBP)	13
Unfunded Liability in State Pension Funds	13
State Fund “Old Fund” Liability	13
Ballot Initiative – CI-97	14
Federal Deficit Reduction Act - DPHHS	14
Federal Funds	14
Wildfire Funding – Changes in Federal Reimbursement	14
Inflation/Energy Prices	14
New Proposals and Other Initiatives	15
Proposed Tax Relief Rebate Measures	15
SB 495 Loan Repayment Schedule	15
Interest Earnings	15
Economic Uncertainty and Revenue Trends	15
Structural Balance	17
Summary	18
Appendix a	19
Basic Assumptions Used in Present Law Projections	19
Concept of Present Law	19
Revenues	19
Expenditures	20

INTRODUCTION

PURPOSE

The purpose of this report is to provide the Legislative Finance Committee (LFC), the Revenue and Transportation Interim Committee, and the members of the legislature with a preliminary projection of the general fund balance for the 2009 biennium at present law levels of revenue and expenditure. The projection estimates the availability of funding for maintenance of existing services as well as for new and expanded programs. This report is intended to provide a broad overview of the scope of present law fiscal issues the legislature may face in the 2007 session, and the starting point, or benchmark, for crafting the 2009 biennium budget priorities. These projections are based on "broad brush" general assumptions of expenditure and revenue patterns from the most current available information, and will be refined as staff undertakes detailed budget analysis and revenue estimation in preparation for the 2007 legislative session.

The assumptions used in making the projections and the adjustments made to derive present law are discussed in the body and appendix of the report.

SCOPE OF REPORT

As described above, this report focuses on the projected present law fund balance in the general fund. In addition to the projection, it includes: 1) a discussion of the assumptions used to derive the present law projections; 2) a summary of the adjustments made to derive present law; 3) recommended LFD adjustments; 4) significant issues not included in the projections due to an uncertain or unknown impact; and 5) a discussion of the structural balance in the general fund account.

Present law levels represent the amount necessary to continue programs and services authorized by the previous legislature, and include caseload and workload increases, and enrollment adjustments. Statute requires that the executive submit a present law budget to the legislature and that the Legislative Fiscal Analyst (LFA) provide an analysis of present law.

The projections do not include other fiscal issues that may face the 2007 Legislature, including executive or legislative new proposals/initiatives, other potential FY 2007 supplementals, pending litigation cases, or the potential impact of voter initiatives. These and other issues are listed in Table 3 and are discussed beginning on page 10 of this report.

“MODEL” APPROACH

The projections in this report estimate revenues and expenditures of state government for nearly three full years into the future. Even though the methodology used is based on a statutorily defined budget process, there is still room for debate as to the details of those calculations, and the assumptions used in making the projections. Further, the projections are made within a volatile, dynamic environment, not the least of which is the unpredictable nature of economic forecasting, which is subject to political, demographic, and other impacts. As such, the acceptability of the projections is going to be subject to the unique political and other perspectives of the reader.

In an attempt to make the projections as useful as possible to a diverse audience, the analysis is presented in a 3-step model, as reflected in the 3-part table on page 3.

Table 1 – Statutory Present Law

Table 1 reflects only those projections that fit neatly into the statutorily prescribed definition of present law. Caution is encouraged, however, in relying solely on that projection in assessing the factors the legislature needs to take into consideration in adopting a balanced budget for the 2009 biennium. It does not take into consideration what is considered a prudent ending fund balance reserve, nor does it include any reserve for unbudgeted but likely major expenditures such as wildfire suppression and other natural disasters.

Table 2 - Reserves

Factoring in a reserve for an ending fund balance and such known issues as fire and other emergency costs is critical to good fiscal policy, and as such, recommended estimates for such allowances are provided in Table 2, largely based on historical actions by the legislature and on sound fiscal practice. They are, however, subject to less clarity than the estimates in Table 1, and the distinction is made on these more “policy oriented” issues so that the reader can draw a separate and distinct conclusion about the merits of these estimates. In general, however, the projected fund balance after taking into consideration LFD recommended adjustments is likely to be a more realistic projection of the level of funds available after funding present law and adequate reserves. Table 2 also addresses the issue of structural balance, identifying the amount of the excess that can be spent without creating structural imbalance.

Table 3 – Potential Impacts Not Included

Yet another distinction is made in Table 3 for those issues with potential impacts on the 2009 biennium budget for which the budget impact is either highly uncertain or unknown, depending on subsequent economic or other events. A prime example is the impact of the CI-97 expenditure limitation initiative, which is being challenged in the courts. Inclusion of this or any of the other issues in Table 3 in the projections would be highly speculative at this point, but clearly they need to be considered in any assessment of the budget picture for the 2009 biennium, and in legislative deliberations to balance the budget.

It is strongly recommended that all three levels of information be taken into consideration in developing conclusions about the budget projections for the 2009 biennium. By presenting it in this 3-tier fashion, it allows the reader to use the presentation as a model, and to “pick and choose” their estimates for the items, particularly in Tables 2 and 3, in arriving at their own perspective of the status of the 2009 biennium budget outlook.

2009 BIENNIUM BUDGET PROJECTION

PROJECTED GENERAL FUND BALANCE

Present Law

The projected present law ending general fund balance for the 2009 biennium before reserves is \$902.7 million (Table 1), and is reduced to \$751.1 million (Table 2) when allowing for a 3.0 percent ending fund balance reserve,

a reserve for wildfire suppression costs, and a reserve for expenditures from the emergency fund appropriation. This total represents an available balance for policy decisions on prioritization of present law expenditures, new initiatives, tax reform, and an appropriate general fund reserve.

As discussed in the previous section, Table 1 represents only those projections that fit the statutorily prescribed definition of present law. It is not, however, a complete picture of the available fund balance, since it doesn't take into consideration an adequate fund balance reserve or allowances for fire and emergency costs. Factoring in an allowance for these issues is sound fiscal policy, and since they generally represent policy oriented issues of the legislature as to the amount of the allowance, they are singled out individually and are presented as LFD recommendations in arriving at a more realistic projection of the level of funds available after funding present law and adequate reserves. These recommendations are discussed in more detail beginning on page 9.

The projections do not include allowances for other potential fiscal issues with an uncertain or unknown impact (Table 3). Although not included, the reader should be aware of these potential impacts and factor them in to their assessment and conclusions about the general fund outlook for the 2009 biennium. Each of the issues in Table 3 are discussed beginning on page 10.

While Table 2 shows a present law excess after reserves of \$751.1 million, it is important to consider the issue of structural balance of the general fund before concluding whether the entire excess can be used for state services and tax policy initiatives of an ongoing nature. For the

2009 Biennium General Fund Outlook			
In Millions			
Table 1			
Beginning Fund Balance (Before Supplementals)			\$578.250
Anticipated Revenue			\$3,613.983
Disbursements			
Fiscal 2007 Supplementals			69.300
Fiscal 2006 Base times 2 (Excl. stat. approps.)			2,533.328
Present Law Adjustments			383.990
Public Schools		147.877	
Public Health		89.875	
Corrections		64.335	
Higher Education		17.962	
Judiciary		(12.381)	
All Other Agencies		60.049	
Other Adjustments		16.273	
Fiscal 2006 Base times 2 (Stat. approps. + trnf.)			289.004
Present Law Statutory Appropriations			40.230
Present Law Transfers			(30.117)
Feed Bill and Reversions			3.826
Total Disbursements			\$3,289.561
Projected Balance Without Reserves			\$902.672
Table 2			
LFD Recommended Reserves			
3.0 % Fund Balance Reserve		108.419	
Wildfire Suppression Cost Reserve		26.688	
Emergency Appropriation Reserve		16.500	151.607
Projected Present Law Excess			\$751.065
Projected Present Law Excess Components			
Revenue Less Disbursements			\$350.534
Remaining Balance			\$400.531
Table 3			
Other Significant Issues Not Addressed Above			
Other Potential 2007 Biennium Supplementals			
2009 Biennium Pay Plan			
Litigation Issues			
K-12 Funding Adequacy			
State Fund Lawsuits			
Human Services - MAIDS			
PPL Protested Tax			
Long-Range Building Program Deficit			
Unfunded Liability in State Pension Funds			
State Fund "Old Fund" Liability			
Ballot Initiative - CI-97			
Federal Deficit Reduction Act			
Federal Funds			
Wildfire Funding - Changes in Federal Reimbursement			
Inflation/Energy Prices			
New Proposals and Other Initiatives			
Proposed Tax Relief Rebate Measures			
Reduced Investment Earnings			
Economic Uncertainty and Revenue Trends			

2009 biennium, anticipated revenues exceed present law disbursements by \$350.5 million (Table 2). Therefore, \$350.5 million of the projected \$751.1 million projected excess could be used for ongoing state services growth or tax policy initiatives without creating a structural imbalance. The remaining \$400.5 million should only be used for one-time initiatives if a structural balance is to be maintained. For a further discussion of this issue, see the discussion of "Structural Balance" on page 17.

The nearly \$751.1 million projected present law excess provides a stark contrast from the \$230 million negative balance the 2003 legislature originally faced in crafting a budget for the 2005 biennium, which left insufficient funds to even continue existing programs and services at current levels. It is even a notable contrast to the \$205.9 million positive balance originally faced by the 2005 Legislature when developing the 2007 biennium budget. In fact, the beginning fund balance represents the largest balance available to the legislature compared to any prior biennium. The primary factor that has contributed to this strong budget picture is a significantly stronger than anticipated growth in actual and projected general fund revenue collections (primarily individual, corporate and oil and gas production taxes).

ADJUSTMENTS APPLIED TO DERIVE PRESENT LAW

This section discusses the specific monetary adjustments that were made in deriving a present law projection. For a discussion of the underlying assumptions used in arriving at these adjustments, i.e., the concept of present law and the assumptions used to establish a framework for revenue and expenditure adjustments, see Appendix A in the back of this report.

Table 1 represents only those projections that fit neatly into the statutorily prescribed definition of present law. The table shows the anticipated revenues and a breakdown of the expenditure adjustments to the base budget to arrive at a present law budget. The major factors causing the changes as shown in Table 1 are discussed below.

Revenues

General fund revenues of \$3.457 billion for the 2007 biennium are anticipated to increase by \$157.1 million to \$3.614 billion for the 2009 biennium, a growth rate of approximately 2.2 percent per year. Individual income, corporation income, and oil and natural gas production taxes are the three sources critical in determining the fiscal status for the 2009 biennium.

Individual income tax is expected to increase by about 9.3 percent during the 2009 biennium, while corporation income taxes are expected to decline by almost 20 percent. Growth in individual income taxes is consistent with the anticipated growth in Montana wage and salary income. Corporation income taxes are expected to decline from FY 2006 as Montana's economy returns to a more moderate growth level and commodity prices abate from historically high levels.

The oil and gas industry in Montana has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. Increased production combined with higher prices has resulted in an improved state revenue picture. Total oil and gas production revenues are expected to be \$438.8 million for the 2009 biennium, which is up dramatically from the 2005 biennium revenues of \$230.4 million. This projection reflects recent high oil prices with the expectation that oil prices will moderate during the 2009 biennium.

Interest rates are also expected to remain stable at the present level. In the general fund, treasury cash account interest is expected to decline from \$43.5 million in the 2007 biennium to \$37.1 million in the 2009 biennium. This decrease is anticipated as the average invested cash balance declines in anticipation of the legislature adopting spending and/or tax initiatives above present law.

It must be emphasized that the estimates in this report are based on the premise that the unusual high revenue growth in the past three years has peaked and will abate in subsequent years. This conservative approach is appropriate to minimize the downside risks associated with revenue estimates that are relying on dated data, and recognizing that more current data will be available in a few weeks that could significantly change the outlook.

Expenditures

The projections for the 2009 biennium show that the costs of present law budget would be a base budget of about \$2.822 billion plus adjustments of \$467 million, for total present law disbursements of \$3.289 billion. The major factors causing the \$467 million in adjustments are summarized below.

2007 Biennium Known Supplemental Appropriations

Five supplemental requests totaling \$69.3 million are very certain at this time, and are included in the present law adjustments, Table 1.

- Public Defender – The newly created Office of the Public Defender (OPD) took over provision of services for indigent persons on July 1, 2006. Costs are anticipated to exceed the appropriation by about \$3.3 million in FY 2007 if current conditions persist
- Judiciary - Increases in costs, primarily for legal representation for indigent persons (public defender), resulted in a supplemental transfer in FY 2006 of \$2.5 million. These costs are the responsibility of the OPD beginning in FY 2007, but the Judiciary will request that the FY 2006 transfer be paid as a supplemental for FY 2007. While staff estimates costs could be \$3.0 million when bills not yet processed/received are included, this additional \$500,000 is less certain and therefore included in a later section of the report
- Corrections - Prison population increases greater than the level included in the 2007 biennium budget, new programs, increased per diem rates, and other cost drivers will result in a supplemental appropriation request, currently estimated at \$25.0 million
- DPHHS – Estimated supplemental costs total \$9.3 million due to two factors: 1) cost overruns at the Montana State Hospital; and 2) an increase in the percent of Medicaid costs the state must pay
- Fires – Montana does not budget for fires, and so all costs that are determined to be the responsibility of the state must be paid from the ending fund balance. Total state costs in the 2007 biennium, including an estimated \$1.0 million in spring fires and minus all costs paid for with the Governor's statutory emergency fund, total \$29.2 million

It is emphasized that these supplemental projections are included because they are very likely to occur based on best available information and there may be other cost over-runs. These issues are discussed under "Significant Issues Not Included in 2009 Biennium Projections", page 10.

Public Schools

The present law budget for the Office of Public Instruction will increase by \$147.9 million in the 2009 biennium compared with the amount spent in FY 2006 doubled. The primary reasons for the increase are:

- Present law general fund BASE Aid to school districts in the 2009 biennium will increase by \$66.1 million. This increase is made up of the following components:
 - Continued decline in enrollments, between 0.6 percent and 0.7 percent, which is less than declines of recent years in the neighborhood of 1.1 to 1.2 percent. Elementary populations are rising due to higher birth rates beginning in 2000, as well as due to immigration. High school enrollments continue to decline but at slower rates.
 - Increase in entitlements by inflation. Inflation is expected to be 2.76 percent in FY 2008 and 2.97 percent in FY 2009. The net impact of lower enrollments and inflation adjustments is \$47.6 million in the 2009 biennium.
 - Lower estimates for revenue from interest and income (I & I) on state lands, which was \$66.6 million in FY 2006. As I & I increases or decreases BASE Aid paid for out of the general fund decreases or increases. The most recent estimates of I&I are \$57.5 million in FY 2008 and \$57.3 million in FY 2009. Thus, due to lower I&I estimates general fund BASE Aid will increase by \$18.5 million.
- The special session in December 2005 added \$33.8 million in FY 2007 to BASE Aid in the form of four new components: Qualified educator, Indian education for all, at risk, and close the American Indian

achievement gap. These were ongoing expenditures and will amount to an additional \$70.6 million in the 2009 biennium (One-time only additions of \$34.4 million in FY 2007 are not included).

- Other adjustments include: a) removing one-time only appropriations from the agency appropriation for the student database; b) annualization of amounts not fully spent in FY 2006 but expected to be spent in the 2009 biennium; c) growth in HB 124 block grants and transportation; and d) school facility reimbursements for new and expected debt service building bonds in several districts.

Public Health

DPHHS expenditures were \$1.2 billion - nearly 23 percent of total statewide expenditures in FY 2006 - and accounted for \$308 million general fund or 16.5 percent of total general fund expenditures. General fund present law adjustments for DPHHS are projected to be \$89.9 million to support ongoing costs in both years of the 2009 biennium, a 16 percent increase compared to the 2007 biennium appropriation. The lion's share of the present law adjustments will fund current level Medicaid services costs. Paying for increases in the number of services used, drug price inflation, and enhancements in medical technology adds \$49.5 million general fund over the biennium.

General fund costs to pay the increase in the state Medicaid match rate¹ add another \$32.1 million over the biennium. The state match rate is projected to increase from 29.43 percent in FY 2006 to 32.10 percent in FY 2008, slightly higher than the average Montana state match rate since the inception of the Medicaid program at 32.07 percent. Each 1 percent change in the state match rate results in a \$7 million shift in state funding.

Foster care, subsidized adoption, and child care increases add \$10.7 million over the biennium, including changes in the federal match rate for foster care of \$0.4 million.

The analysis includes the cost of the net \$1.3 million supplemental as ongoing. Since the bulk of the cost over run was due to over crowding at the state hospital and the addition of about 37 new FTE, the legislature will still need to decide whether to add new funding for the FTE.

The analysis also reduces general fund costs by about \$3.7 million since the cost of some Medicaid provider rate increases was funded by tobacco taxes (I-149) and general fund. The 2005 Legislature added the general fund in order to allow the health and Medicaid initiatives account balance to grow to \$25 million, an amount the legislature believed would sustain new health programs funded with increased tobacco tax over several years. This analysis shifts the entire cost of continuing the Medicaid rate increases to tobacco funding.

Corrections

Department of Corrections present law budget increases are primarily due to increases in the average daily population (ADP) of adult offenders under the supervision of the department and annualization of new or existing program expansions.

- The total adult ADP grew 8 percent between FY 2005 and 2006. This report estimates an overall growth rate of 7 percent per year from FY 2006 through FY 2009. The growth rate in the overall ADP has ranged from 3 percent to 8 percent with the 8 percent increase occurring in the most recently completed fiscal year. Male adult secure care population growth is estimated at 6 percent and the female adult secure care growth rate at 17 percent per year.
- Present law adjustments also include annualization of costs for new or expanded programs including expansion in pre-release and contract beds, and implementation of a new revocation center (opened in December 2005) and two methamphetamine treatment centers that are expected to open in the spring of 2007.

¹ The state Medicaid match rate is determined by changes in each state's per capita income compared to the national average per capita income. Changes in the federal medical match rate also impact state funding requirements for foster care and the Children's Health Insurance Program (CHIP).

Higher Education

Historically, one of the primary present law budget drivers for the university system has been student enrollment increases at both the university unit campuses and at the community colleges. Enrollment increases over the past decade (1997-2006) have been about 7 percent at the units and 11 percent at the community colleges.

Going forward into the 2009 biennium, the university units are projecting student enrollment increases of 558 FTE students in FY08 and 734 FTE in FY09 (an average of 1 percent per year), while the community colleges are projecting enrollment increases of 276 in FY08 and 377 in FY09 (an average of about 8 percent per year). Projecting these increases into general fund present law adjustments for the 2009 biennium budget results in an expenditure increase of \$2.4 million for student enrollment increases at the university units (\$1.2 million per year) and \$1.8 million at the community colleges (\$.9 million per year).

In the current biennium, however, enrollment has been volatile as both the university units and the community colleges have experienced actual student enrollment shortfalls from their FY06 enrollment projections, and they are now projecting shortfalls in FY07 as well. Given the student enrollment reversion statute (17-7-142, MCA) the university system is projecting a potential \$2.6 million general fund reversion at the end of the 2007 biennium as a result of these enrollment figures.

Another substantial present law adjustment expenditure in the 2009 biennium budget is \$3.4 million (\$1.7 million per year) to fully fund the Governor's Postsecondary Scholarship Program. This program was approved by the legislature in the 2005 session, but the scholarship expenditures for this program will increase during the upcoming biennium budget as the "pipeline" of students receiving scholarships will be full as students reach their third and fourth years of eligibility for the scholarship awards.

The remainder of present law adjustments are primarily infrastructure and other operations and maintenance costs of the campuses and research agencies.

Judiciary/Public Defender

The 2005 Legislature created the Office of the Public Defender by transferring responsibility for representation of indigent persons from the Judiciary and counties, beginning July 1, 2006. This transfer results in the net decrease in costs for the Judiciary in the 2009 biennium. During FY 2006, the Judiciary overspent its appropriation by about \$3.0 million, primarily due to higher than appropriated indigent client costs. These additional costs are not carried forward into the 2009 biennium within the Judiciary, as they are no longer responsible for the costs. However, both this over-expenditure and the additional expenditures anticipated for FY 2007 in the Office of the Public Defender are included in the "All Other Agencies" category at a total of \$6.6 million over the biennium.

All Other Agencies

This category includes \$60.0 million for present law adjustments in agencies of state government not included in other categories. This includes the natural resource agencies and the "administrative" agencies of state government, including the Departments of Administration, Revenue, and Justice.

Other Adjustments

"Other Adjustments" consist of various changes made to the FY 2006 base, including the costs of the 2007 biennium pay plan in the 2009 biennium (see below), inflation, and fixed costs. Some of the more significant adjustments are explained below. The vacancy savings rate was maintained at the 2007 biennium HB 2 level of 4 percent for all positions (with limited exceptions). Annualization of any phased-in or phased-out programs, adjustment of biennial appropriations, elimination of all one-time-only appropriations, full-funding of FTE upon which personal services funding was based in the 2007 biennium, are included in the previously discussed individual categories.

Pay Plan

The legislature provided both a salary increase and increased monthly insurance contributions in the 2007 biennium. Salaries were increased by 3.5 percent (or \$1,005, whichever was greater) starting October 1, 2005 and by a further 4.0 percent (or \$1,118, whichever was greater) starting October 1, 2006. Insurance was increased by \$46 per month on January 1, 2006 and a further \$51 per month on January 1, 2007. Because all increases were phased in not only during the biennium but during the fiscal year, FY 2006 only represents a portion of the costs to fully implement this pay plan in the 2009 biennium.

The total general fund cost to fully implement the 2007 biennium pay plan in the 2009 biennium is \$59.8 million, or \$39.3 million over the doubled FY 2006 base. The present law adjustment reflects the difference between the total cost in the 2009 biennium and the amount already included in the individual figures above. (Please note that the figures assume 40 percent general fund for the Montana University System.)

Fixed Costs

“Fixed costs” are charges made to agencies for the costs of the provision of certain centralized functions of state government. Among the fixed costs are information technology services, insurance, various administrative functions such as payroll, motor pool, grounds and maintenance, and accounting system debt service. Fixed costs will rise primarily due to the net of increases in SABHRS costs, data network charges, and rent, partially offset by a decrease in insurance.

Vacancy Savings

Vacancy savings is the difference between the cost of fully funding positions for the entire year, and the actual cost of authorized employee positions during that period. While vacancy savings is not considered a present law adjustment, the legislature has consistently applied a vacancy savings at the rate proposed by the Governor. Consequently, a 4 percent vacancy savings is assumed in all present law calculations. Vacancy savings is about \$30 million over the biennium.

Inflation

The statutory definition of present law states that inflationary adjustments should be added in preparing a present law budget. However, the budget as presented by the Governor and the budget adopted by the legislature for several biennia has included not only very selective inflation adjustments, but offsetting deflationary adjustments. Primarily due to energy costs (including motor pool) and postage, inflation is included at \$4.8 million.

Statutory Appropriations

General fund statutory appropriations increase \$40.2 million from the present law biennial base. The change is due primarily to retirement contributions, local government entitlements, debt service, emergency appropriations, and property tax reimbursements.

- Because two large police and firemen retirement system payments totaling \$15.7 million were not made in FY2006, present law increases by \$34.6 million
- For the 2009 biennium, appropriations to local governments authorized by House Bill 124 (2001 session) increase \$10.3 million due to increases in the statutory calculated growth rates
- Debt service payments increase in FY2006, FY2007 and FY2008 and decline in FY2009 for a net increase of \$1.6 million
- Base expenditures for emergencies were \$1.0 million. Since the \$16.5 million appropriation for emergencies is accounted for in the balance sheet under “Reserves” rather than “Statutory Appropriations”, there is a decline of \$2.0 million.
- Property tax reimbursements decline by \$6.0 million according to the statutory formula and the program terminates after FY2008

Transfers

Transfers of money out of the general fund decrease \$30.1 million from the present law biennial base. The difference is due primarily to two large transfers in FY2006 that will not occur in the 2009 biennium.

- Transfer to the cultural trust for a decrease of \$6.8 million (HB 9 2005 session)

- Transfer to the Long Range Building Program for a decrease of \$21.4 million (HB 5 2005 session)

Feed Bill

The “feed bill” funds the cost of the legislative sessions and other interim activities. A total \$8.0 million is included for those costs in the 2009 biennium (2007 legislative session) which includes \$1.0 million for carryover 2005 legislative session costs.

LFD RECOMMENDED ALLOWANCES

In addition to the projections in Table 1 that most clearly fit into the statutory definition of present law, the LFD recommends that three other adjustments be made in projecting a more realistic outlook of the funds available for the 2007 legislative session above present law funding (Table 2). They include leaving an adequate ending fund balance reserve, a reserve for wildfire suppression costs, and a reserve for declared emergencies. Each of these issues is discussed below.

Adequate Ending Fund Balance Reserve

An ending fund balance reserve provides a cushion for variations in actual revenue collections versus projections and for unanticipated expenditures (supplementals/statutory appropriations). Statute requires a minimum ending fund balance reserve of 1 percent of total appropriations (approximately \$35 million). It would not be good budget management, however, to leave an ending fund balance projection that only meets the minimum, since any negative decline from projections would trigger statutorily required budget balancing action by the executive. Plus, a 1 percent reserve for a biennial budget that is subject to significant fluctuations in revenue estimates and potential supplemental appropriation demands simply does not provide an adequate cushion for unanticipated events.

Recently, the general fund reserve set by the legislature has been above \$75 million, or over 2 percent of total biennial revenues. While a minimum reserve of 3 to 5 percent is recommended by national experts, it is recognized that in prioritizing a budget, it is difficult to attain. The Legislative Fiscal Division (LFD) suggested minimum adequate ending fund balance reserve is 3.0 percent, or \$108.4 million. This amount compares to a \$76 million ending fund balance reserve adopted by the 2005 legislature in regular session for the 2007 biennium, and \$229 million in special session (December 2005). This suggested fund balance reserve is only a guideline and is included to provide a more realistic measure of the excess funds available. Ultimately, the determination of an adequate fund balance reserve is a policy decision of the legislature. For reference, each 1 percent of reserve set-aside funds is \$36.1 million.

Wildfire Suppression Costs

The present law budget projections in Table 1 do not include any estimate for the ever-present cost of wildfire suppression. The legislature traditionally has not budgeted for the costs of fighting wildfires. As a consequence, the ending fund balance reserve must cover all expenses, and the traditional reserve is arguably not adequate to cover the liability fire costs have been in recent biennia. Even if it was sufficient, as is the case in FY 2007, there is insufficient appropriation authority to access the fund balance to pay the bills. The \$41.9 million in state fire costs for the 2007 biennium far exceed the available appropriations in the emergency fund, and there is no other appropriation authority to pay the incoming bills. Accounting “end arounds”, loans, and other stop-gap measures must be used to avoid the need for a special session to obtain appropriation authority, and it is still not assured a special session can be avoided.

Given that the state incurs significant wildfire costs each year, some allowance for these costs should clearly be included in any biennium ending fund balance projection. Although the cost of fighting wildfires can fluctuate significantly from biennium to biennium, a five year average, removing the high and low years (FY 2007 and FY 2003, respectively), is \$13.3 million per year. This number is used in Table 2 (\$26.7 million for the biennium) to represent anticipated fire costs in the 2009 biennium. It is emphasized that this is a very conservative number,

when considering that the annual costs of wildfire suppression have grown dramatically in recent years, and that federal reimbursement for wildfire costs have decreased (see discussion on page 14)

Emergency Fund Appropriation

The legislature has approved a statutory appropriation of \$16.5 million general fund each biennium for the Governor to deal with declared disasters or emergencies such as floods, fires, and other natural disasters. Yet, even though the authority exists to spend this appropriation under specific emergency circumstances, the legislature has never included any of it in its budget and projected ending fund balance as biennial budgets are set. However, in the 2003 session, the 58th Legislature amended appropriations statute in order to clarify that the legislature must not only budget in good faith for a balanced budget, it must also achieve a positive ending balance at the end of the biennium. This change reinforces the argument that it is sound fiscal policy to include this appropriation in the projected budget and ending fund balance, just as is done for all other statutory appropriations. LFD recommends that a reserve for \$16.5 million be included in the projection of the 2009 biennium available funds.

SIGNIFICANT ISSUES NOT INCLUDED IN 2009 BIENNIUM PROJECTIONS

There are other issues with potential material impacts on the 2009 biennium budget for which the fiscal impacts are either uncertain or unknown, and consequently are not included in the projections. Additionally, economic events could produce unanticipated changes in revenue projections. In the event that any of these become reality, there is a potential for impacts to the general fund balance. While not included in the fund balance projections, it is important that the potential impacts be considered in the legislative deliberations to balance the 2009 biennium budget. Where feasible, a cost estimate or potential cost range is provided to assist the reader. Each item is discussed briefly below.

Other Potential 2007 Biennium Cost Over-runs (Supplementals)

In addition to the almost certain supplemental appropriations included in Table 1 in the 2009 biennium projections, based on current information, there are three other areas with potential cost over-runs that could result in FY 2007 supplemental requests. While the amounts are unknown at this time, there is a high likelihood of a request. It is important to be aware of these potential over-runs, but they are not included because the executive has the option to mitigate these cost over-runs by re-prioritizing or applying cost savings measures.

- Judiciary – As stated, not all bills for indigent defense are known to have been received and/or processed, and the Judiciary’s cost may increase by up to another \$500,000.
- DPHHS - Deficit reduction measures adopted at the federal level in FY 2006 have many unknown fiscal impacts at the time of this writing. Consequently, DPHHS could incur additional costs not currently accounted for in the supplemental totals on page 5. Also see the “Federal Deficit Reduction Act” discussion on page 14
- Fire Costs – Additional costs in this fire season (which is not yet officially over) and concerns over additional spring fire costs in excess of the current estimate could result in a higher supplemental figure.

2009 Biennium Employee Pay Plan

As of this writing, no pay plan proposal for the next biennium has been officially discussed, and none is assumed in any of the present law calculations in this report. However, a proposal is likely to be presented to the legislature by the Governor. For purposes of perspective, each 1 percent increase in salary effective October 1 of each year of the biennium would cost about \$7.6 million general fund in the 2009 biennium, with an ongoing 2011 biennium cost of about \$9.0 million, assuming 40 percent general fund for the Montana University System. Each \$10 per month insurance increase each year of the biennium, effective on January 1, would cost approximately \$2.5 million. A vacancy savings rate of 4 percent is assumed for both calculations.

Litigation: K-12 Funding Adequacy

On April 15th, 2004, the Helena District Court under Judge Sherlock found the Montana system of funding K-12 education unconstitutional. The Sherlock decision found that the state share of school spending was inadequate,

and the current funding formula was not rationally related to educationally relevant factors. In addition, the Sherlock decision found the State has failed to recognize the distinct and unique cultural heritage of American Indians and has shown no commitment in its educational goals to the preservation of their cultural identity.

In March 2005, The Supreme Court issued an opinion affirming the District Court in all its findings. The Court ruled that in order to construct a basic system of free quality public schools, the legislature must define what constitutes quality and create a funding formula correlated to that definition.

In response to the Supreme Court's decision, the legislature made substantial changes to Montana's school funding laws during the 2005 regular and special sessions. In the 2005 regular session the legislature enacted SB 152, which among other things defined a basic system of free quality public schools. SB 152 also required the legislature to develop a mechanism to fund the basic system and required that such a formula be enacted by July 1, 2007. In addition, the legislature appropriated an additional \$91.4 million for K-12 and OPI for more Base Aid and for Indian Education for all, among other increases. The percent increase above FY 2004 levels of Base Aid was 7.2 percent in FY 2006 and 8.0 percent in FY 2007.

In the 2005 regular session, the legislature also enacted SB 525, which created the Quality Schools Interim Committee to assess and study the costs of providing a basic system of quality public schools and provide the legislature with recommendations on the construction of a new funding formula. The QSIC developed a new funding formula based on 5 new components in the district general fund: a per-student component, an accredited programs component, a classroom component, an operations and maintenance component and a special education component. These components were based on known expenditure data for fiscal 2004. The entire cost of the proposals was an additional \$241 million in state and local aid for K-12 per year.

The December 2005 special session, building in part of some of the work of QSIC, created 4 new ongoing Base Aid components: a quality educator component, a close the American Indian achievement gap component, an at risk component, and an Indian education for all component, increasing ongoing state aid in FY 2007 by \$36.9 million. In addition the legislature provided one-time funding of \$32.0 million for Indian education for all, operation and maintenance, and energy cost relief. An additional \$2.5 million was appropriated for a K-12 facility condition study.

In June 2006, the plaintiffs in the original case, the Montana Quality Education Coalition (MQEC), filed a motion with the district court requesting that Judge Sherlock schedule a show cause hearing at the conclusion of the 2007 session to ascertain if the state has met its obligations under Sherlock's district court finding on inadequacy in state funding for K-12. The Attorney General urged Judge Sherlock to reject this request because the two intervening legislative sessions made the issue moot. Judge Sherlock, in August 2006, ruled that it was premature to schedule a show cause hearing for after the 2007 legislative session. Sherlock invited the plaintiffs to re-apply after the 2007 session. In the meantime, MQEC has hired consultants to assess the costs of a quality system of free public schools using the professional judgment and successful schools methodology. The results of these studies will be available for the 2007 session.

Litigation: State Fund Lawsuits

Three court cases brought against the Montana State Fund could increase the shortfall in the Old Fund by up to \$124 million. The general fund would have to cover any shortfall in this fund.

- *Stavenjord* is pending on decision of the Montana Supreme Court in regards to retroactivity and common fund status. This case relates to the failure of the Occupational Disease Act to provide the same permanent partial disability benefits for occupational diseases as provided for injuries. The Montana State Fund estimates the potential estimated benefit costs to be between \$5 and \$7 million to the Old Fund if the court requires the case to be applied retroactively to 1987.
- *Reesor* – The Montana Supreme Court determined that the practice of denying permanent partial disability benefits to persons who are receiving social security benefits or are eligible for full social security retirements benefits violates the Equal Protection Clause of the Montana Constitution. The case is pending on decision of the Workers' Compensation Court regarding establishment of a common fund

and retroactivity. Montana State Fund staff estimate a potential estimated benefit cost increase of \$1 million to the Old Fund if the decision is held to apply retroactively.

- *Satterlee* challenges the constitutionality of terminating permanent total disability and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. A Montana Workers' Compensation Court judge ruled in favor of the respondents/insurers (including Montana State Fund) in December. A request for reconsideration of the case is pending in the Montana Workers' Compensation Court and a ruling is expected shortly. If the request for reconsideration is denied, the legal counsel for the Montana State Fund anticipates the case will be appealed to the Montana State Supreme Court. A decision by the court could be expected in mid to late 2007, after the end of the 2007 session but prior to the beginning of the 2009 biennium. The potential estimated benefit costs for non-settled permanent total disability claims, if the statute is ultimately held to be unconstitutional and to apply retroactively, is between \$93 and \$116 million for the Old Fund.

Litigation: Human Services – MAIDS

In September 2002, the Montana Association for Independent Disability Services, Inc. (MAIDS) and several individuals with developmental disabilities filed suit. This suit alleges that the disparity in wages and benefits paid to employees of community based providers verses the wages and benefits paid to employees of state institutions has resulted in irreparable and unnecessary harm to the plaintiffs. The plaintiffs allege that several statutory and constitutional provisions have been violated and seek to: 1) have the wage and benefit disparity between employees of state run institutions and community providers eliminated; and 2) to have uniform Medicaid reimbursement rates established. The court is scheduled to hear the case by May of 2007. A finding in favor of the plaintiffs requiring the state to establish direct care wage rates that are comparable to state employees could have a multi-million dollar impact on the state. It is also possible that other contractors with direct care wages could file similar law suits.

Litigation: PPL Protested Taxes

PPL Montana (PPL) a subsidiary of Pennsylvania Power and Light (PPL) has protested a portion of its property taxes every year since tax year 2000. Before passage of SB 294 in the 2003 session these taxes were paid into an escrow account and were unavailable for use by the state, local governments and schools. SB 294 allowed the state share of these taxes to be deposited in the state general fund. In the 2005 session this distribution was changed by SB 87 which directed that half the protested taxes be deposited in a state special account, and saved, and the other half in the general fund.

PPL appealed to the State Tax Appeal Board (STAB), contending: 1) that the DOR improperly centrally assessed the property; 2) the DOR improperly included tax exempt intangible personal property; 3) the DOR improperly valued the pollution control property at its Colstrip units; and 4) that the valuation of their properties was unconstitutional because when its valuations are compared to valuations of like property owned by other generation utilities in the state, PPL properties were valued considerably higher. The PPL appeal for tax years 2000 through 2002 was decided February 11, 2005 by STAB which ruled in favor of the state for tax years 2000 through 2002 regarding whether the property should be centrally assessed and on whether the DOR properly calculated exempt intangible personal property. STAB also adjusted PPL valuations for 2000-2002 in a manner that DOR did not agree with. STAB did not rule on the purely legal issues involving PPL's constitutional claim. PPL has protested and appealed its assessments for tax years 2003 through 2005, but the parties have agreed to hold in abeyance any proceedings regarding these years until a final determination of the case for tax years 2000 through 2002 has been made.

An appeal was heard in Judge Sandefur's district court in Great Falls and a decision was rendered on April 28, 2006. Judge Sandefur ruled for the state and the constitutional claims of PPL were rejected. However, the district court ruled the new valuation methodology employed by STAB was correct.

PPL appealed this decision to the Montana Supreme Court and the case will likely be decided sometime in 2007. The DOR has applied for and was granted an expedited appeal. The state has cross appealed to reject the new valuation methodology employed by STAB.

The total amount of state property tax protested by PPL between 2000 and 2005 is \$7.9 million. This amount has not been adjusted for settlements made between the department and PPL.

The Northwestern protest was for tax years 2005 Northwestern claims that increases in its valuation above 2004 levels are incorrect. The approximate taxable value being protested is approximately \$21.9 million. The case will be heard by STAB February 5th through the 7th in Helena.

There are a few other centrally assessed companies protesting property taxes in tax year 2005. The total taxable value of these protests is \$16.3 million and includes Qwest, Puget Sound Energy, Omimex, Pacificorp, and Encana.

Long Range Building Program Deficiency (LRBP)

The LRBP is the state program charged with the major maintenance of eligible state owned buildings. Funding for the program is deficient and is primarily the result of over two decades of declining revenues in the LRBP. Current LRBP funding is only 20 percent of the industry recommendation for major maintenance. The consequence of the ongoing funding inadequacy is a large and growing deferred maintenance backlog, currently estimated to be \$240 million. Growth in the building asset inventory and inflationary pressures that increase repair costs add stress to an already strained program, a program that will eventually be reduced to a level detrimental to the state's capital assets. Without changes in program funding, only the most urgent of needs, roof replacements and life safety projects, will be funded in the future.

In recognition of the LRBP funding deficiency, the 2005 Montana Legislature appropriated a sum of money through HB 5 to fund a Legislative Finance Committee (LFC) subcommittee study of the funding inadequacy and the deferred maintenance backlog. The LFC appointed an interim subcommittee to analyze the problems and create proposals to address the issues. The subcommittee developed two proposals for the LFC, and the committee requested bill drafts for the proposals. The two proposals include: 1) a rental surcharge assessed by agency based on number of square feet occupied and a renewal rate, developed for each building type; and 2) a deferred maintenance endowment trust. The rental surcharge proposal would address the program funding inadequacy and would necessarily require on-going program costs in excess of the current funding levels. The endowment trust proposal would provide funds to slowly reduce the deferred maintenance backlog and would require a one-time use of funds to establish trust principle. The LFC will take action on the bill drafts in the October 2006 meeting, and if approved the legislature will consider the funding proposals in the 2007 session.

Unfunded Liability in State Pension Funds

Preliminary numbers for the actuarial valuations of four under funded retirement plans as of June 30, 2006, report the unfunded actuarial accrued liability (UAAL) at \$1.3 billion, down from \$1.46 billion a year ago. Asset values for the four retirement plans have increased from \$5.87 billion to \$6.43 billion, a 9.6 percent increase, as investment returns exceeded actuarial assumptions. The increased asset base plus the projected earnings from the additional assets value puts the plans in a more favorable position for being able amortize a larger portion of the UAAL within the required 30-year period, thereby reducing the amount that future legislative action must address. Regardless of the progress reported, these plans still continue to be "actuarially unsound" in violation of the Constitutional requirement and remain one of the primary fiscal issues for the 2009 Legislature.

State Fund "Old Fund" Liability

The Montana State Fund (MSF) provides Montana employers with an option for workers' compensation and occupational disease insurance. Prior to 1990 workers' compensation experienced significant liabilities. The legislature separated MSF liabilities between claims occurring before July 1, 1990 and claims occurring on or after that date. Funds relating to claims prior to July 1, 1990 are referred to as "Old Fund" and those on or after as

“New Fund”. Statutes require that in any fiscal year claims for injuries from accidents occurring before July 1, 1990 are not adequately funded, the funds must be transferred from the general fund. As of June 30, 2005 Old Fund the estimated unfunded liability is \$15.6 million. Eventually, general fund may need to offset this shortfall. Additionally, court litigation of old fund claims could result in over \$100 million additional shortfall, as discussed on page 11.

Ballot Initiative – CI-97

Several voter initiatives were certified for the ballot in November, but only one will have a measurable general fund impact if approved by the voters. Constitutional Amendment CI-97 would place an expenditure limitation on state spending. If approved, it could substantially reduce the amount the legislature could appropriate compared to available funds. However, the measure has been removed from the ballot by two lower court decisions, and both cases have been appealed to the Supreme Court.

Federal Deficit Reduction Act - DPHHS

None of the present law figures in Table 1 include any impact to DPHHS of federal deficit reduction measures included in the 2005 Deficit Reduction Act (DRA), or of the President’s proposed budget. Implementation of the federal Deficit Reduction Act of 2005 (DRA) may reduce federal participation in Medicaid case management services. Depending on final federal guidance, it could take up to \$6 million more in general fund each year to continue case management services for pregnant women, seriously emotionally disturbed children, adults with a serious and disabling mental illness, developmentally disabled adults and children, and those who are physically disabled. The President has also proposed a number of changes that have the potential to reduce federal funding to Montana by more than \$50 million annually, primarily in a reduction in matching funds due to changes in Medicaid provider taxes and for Medicaid targeted case management, and reductions in block grants.

Federal Funds

Montana relies heavily on funding from the federal government for a number of state services. Federal funds are used throughout state government, most notably in human services, environmental and wildlife programs, and transportation. Therefore, any change in discretionary federal spending could have a major impact both on individual programs and the state in general. The federal government is currently facing an extremely large budget deficit. Therefore, it is entirely possible that major adjustments will be made as Congress and the President deal with this reality in the post-election environment. Because work on the federal budget is often delayed until long after the start of the federal fiscal year (October 1), major changes in federal policy and funding levels are often not confirmed until either just before or even during the legislative session. The potential impact to DPHHS of federal deficit reduction are discussed above. However, the legislature may also be faced with budget items that reflect known or anticipated changes due to federal action, including replacement of lost or reduced funds, and adjustments in programs to reflect changing fund availability.

Wildfire Funding – Changes in Federal Reimbursement

The federal government funds a portion of the state costs to fight wildfires through the Federal Emergency Management Agency (FEMA). FEMA has changed the rules that determine which fires qualify for reimbursement, which has decreased federal assistance and increased general fund costs. This scenario is likely to continue into the foreseeable future.

Inflation/Energy Prices

In keeping with past legislative practices, this report does not include a general inflation amount. Instead, certain individual expenditure items are inflated, most notably energy and related expenditures. While energy prices have stabilized, projections for the future vary widely and lend a high degree of uncertainty to this component of state expenditures.

New Proposals and Other Initiatives

In every biennium, the governor requests and the legislature approves increases beyond the present law budget, referred to as “new proposals.” In addition, an employee pay plan and various legislative initiatives are considered and approved. In recent biennia, the total cost of such items has ranged from \$78 million to \$183 million. Since funding for an expanded level budget is not a present law service and is a matter of legislative policy and prioritization, no estimate is included in the 2009 biennium present law projection. The Governor and his budget director, however, have publicly acknowledged several new initiatives, including full-day Kindergarten, zero growth tuition for higher education, and a number of one-time funding initiatives, totaling over \$240.0 million (this does not include a \$100 million property tax rebate proposal discussed below or a proposed \$100 million ending fund balance). In the context of preliminary budget projections, the legislature needs to be aware of the potential, based on historical data, of such requests. Some new proposals, including the pay plan, are discussed separately.

Proposed Tax Relief Rebate Measures

By definition, present law levels represent the amount necessary to continue programs and services authorized by the previous legislature. While this definition is relevant to general fund disbursements, this report is also developed on this definition for tax structure or policies. Any proposed tax relief, rebate, or reform proposal would be considered a new proposal or initiative and has not been included in this report. Both the administration and republican leaders have proposed taxation initiatives.

SB 495 Loan Repayment Schedule

Mineral royalties from common school trust lands are at high levels. This, plus the fact that SB 495 no longer sets a ceiling on the amount of mineral royalties the Department of Natural Resources and Conservation can use to repay the loan of \$46.4 million, gives the department great latitude in choosing how to structure the loan repayment. What they choose to do will affect the general fund balance. If more mineral royalties are used to repay the loan, less will be available to fund public schools and more general fund dollars will need to be appropriated. If less mineral royalties are used to repay the loan, more will be available to fund public schools and less general fund dollars will need to be appropriated.

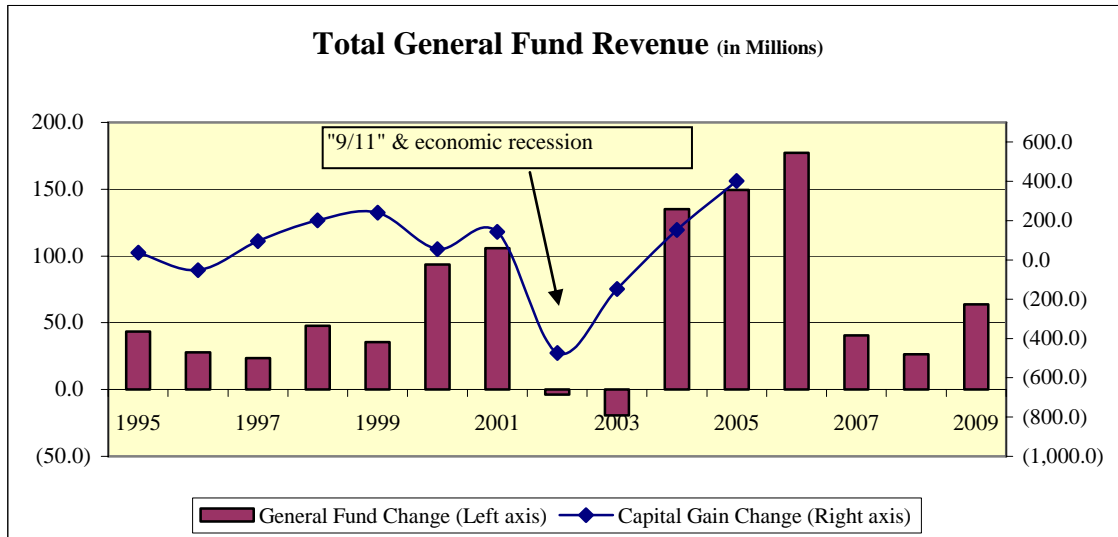
Interest Earnings

Excess cash in the state treasury is invested by the Board of Investments and generates general fund interest revenue. The calculations in this report are based on a budgeted ending fund balance by the legislature of \$100 million for the 2009 biennium. If the legislature appropriates general fund monies above the present law base, timing of the spending may impact invested funds and revenue from this source will be impacted accordingly.

Economic Uncertainty and Revenue Trends

As shown in Table 4, total general fund revenues have increased substantially during the period fiscal 2004 through 2006 and are projected to increase only moderately during fiscal 2007, 2008, and 2009. The projected dollar increases are consistent with the trends observed from fiscal 1995 through 1999. From a percentage growth perspective, however, the projected increases are generally a lower percent than in that previous period. The table also shows that during fiscal 2002 and 2003, a reduction in revenue was experienced at the same time that capital gains and other investment income plummeted. This was due to the “9/11” tragedy and a national economic recession. Conversely, the table also shows that during fiscal 2000 and 2001, state revenue growth accelerated when the nation was experiencing rapid growth in the equity markets due to the proliferation of “dot com” companies and the effect on capital gains income.

Table 4



This data illustrates the sensitivity of Montana's revenue stream to world events and investment opportunities. It also underscores the potential inaccuracies in the revenue estimates if the occurrences of these types of events are not known or are mistimed. Economic upturns or downturns are rarely accurately projected nor can disasters or world developments be anticipated. To quantify current collection patterns, the increased revenue collection of \$462 million from fiscal 2004 to 2006 was primarily due to three general fund revenue sources: individual income, corporation income, and oil and gas production taxes. Together, these three sources of revenue contributed about \$406 million of the total increase, which represents almost 88 percent of the total. The various assumptions used to estimate these revenue sources will have a substantial impact on total estimated general fund revenues in the future. If only a few of the key assumptions miss the mark, estimates may vary widely from actual collections. Key assumptions for these three sources are as follows:

- Montana wage and salary income
- Income from investments (capital gains, interest and dividends)
- Commodity prices (natural resources and agricultural products)
- Corporation profitability.

As stated earlier, the revenue estimates contained in this report are based on economic and accounting information available as of the end of September. For these three revenue sources however, there will be critical information that should be available in November. For example, individual income tax return data for calendar year 2005 will be available November 1. This data will help explain why individual income tax receipts grew so rapidly in fiscal 2006.

Because this new data could significantly change the outlook (positively or negatively) on estimated general fund revenues, the estimates contained in this report are based on the premise that the unusual high revenue growth observed in the last three years has peaked and will abate in subsequent years. This conservative approach was adopted to minimize the downside risk associated with revenue estimates that are predicting amounts almost three years into the future. If the new data supports adjustments to the estimates, revised estimates will be provided to the Revenue and Transportation Committee (RTIC) on November 15. The RTIC is statutorily responsible for establishing revenue estimates to be used by the 60th Legislature.

STRUCTURAL BALANCE

Structural balance refers to the matching of ongoing expenditures of government with ongoing revenues. If anticipated ongoing revenues equal or exceed expenditures, then structural balance is achieved. If expenditures exceed anticipated ongoing revenues, a structural imbalance occurs. Beginning fund balance is not included in the calculation, since any use of the balance is a one-time source of funds.

As shown in Table 2, the present law excess after reserves is projected to be \$751.1 million for the 2009 biennium. Although this excess amount is in stark contrast to previous biennia, it is critical to analyze the structural balance of the general fund account before a conclusion can be drawn about whether additional funds are appropriate for state services and/or tax policy initiatives of an ongoing nature.

For the 2009 biennium, anticipated revenues are expected to exceed present law disbursements by \$350.5 million. The remaining balance \$400.5 million is also available for legislative consideration but should be used only for one-time initiatives if a structural balance is to be maintained. To the extent the 60th Legislature uses any of the \$400.5 million for on-going initiatives; it could result in a deficit budget picture for future legislatures.

Table 5 shows a simplified general fund balance sheet for the 2009 biennium and a hypothetical example for the 2011 biennium assuming a 3.0 percent growth in revenues and disbursements. This table illustrates that if the \$400.5 million present law excess is used for one-time initiatives during the 2009 biennium, the 61st Legislature will not be faced with an anticipated deficit, assuming disbursement growth is kept in concert with revenue growth.

Table 5

General Fund Account Balance Statement		
	Outlook 2009 Biennium	Illustration 3% 2011 Biennium
Balance Statement Components	Millions	Millions
Beginning Fund Balance	\$508.950	\$108.415
Present Law Revenues	3,613.983	3,722.402
Present Law Disbursements	(3,220.265)	(3,316.873)
Emergency/Wildfire Reserve	(43.188)	(44.484)
New Initiatives - Ongoing	(350.534)	(361.050)
New Initiatives - One-Time	(400.531)	0.000
Ending Fund Balance	\$108.415	\$108.410
3.0 percent of biennium revenue		

SUMMARY

The 60th Legislature faces a much brighter budget picture than the large deficit facing the 58th Legislature in the 2003 session, and even the more positive fund balance in the 2005 session. The brighter picture is primarily due to strong growth in individual and corporate income tax and oil and gas tax revenues during the previous 2004 through 2006. The projected present law ending general fund balance for the 2009 biennium is \$902.7 million without reserves, and is reduced to \$751.1 million when allowing for a 3.0 percent ending fund balance reserve and allowances for fire suppression and emergency fund costs. It is emphasized that this is a conservative and responsible estimate for planning purposes, but as more information becomes available before the 2007 session, the available balance could change significantly. This balance leaves the 60th legislature with significant flexibility when prioritizing a present law budget and more opportunities when considering new initiatives, including both new programs and tax policy changes. It is important to keep in mind, however, that there are a number of issues, listed in Table 3 and discussed beginning on page 10, with potential material impacts on the 2009 biennium budget that are not included in the projections. The fate of these potential issues could significantly reduce, or eliminate, the funds available for the 2009 biennium budget prioritization process. In addition, the legislature needs to keep in mind the objective of maintaining a structurally balanced general fund. If structural balance is to be achieved, it is important to note that not all of the projected balance would be available for initiatives and funding of an ongoing nature. Only \$350.5 million would be available for ongoing expenditures, while \$400.5 million should either be held in reserve or used for one-time expenditures.

APPENDIX A

BASIC ASSUMPTIONS USED IN PRESENT LAW PROJECTIONS

Concept of Present Law

The provision of a present law budget projection represents a starting point for legislative budget deliberations, and complements the statutory requirement that the executive and legislative staff present/analyze a present law budget. Present law is defined as “that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature...” Present law serves as a benchmark to aid the legislature in prioritizing budget issues between maintenance of existing services and provision of new services or tax policy initiatives. The projection of a present law budget does not presume the legislature will adopt a budget that retains all existing services. But the executive must present a present law budget to the 2007 legislature, and both new initiatives and reductions or adjustments in existing services must, by law, be presented as new proposals for the legislature to consider in crafting a budget.

Present law projections include 2009 biennium fund balances at present law operations. Present law is used rather than actual FY 2006 expenditures in order to account for inflation and other costs, such as annualization of the state employee pay plan. It is also used because statute requires the executive to submit a present law budget, and the LFD to provide a present law analysis. Present law expenditures are at the levels established by the legislature in the 2005 regular and special sessions for ongoing services, with adjustments for caseload and enrollment increases. The present law projections do not include funding for increases in employee pay, adjustments to the K-12 Base aid funding schedules, or human services provider rate changes beyond the changes made by the 2005 legislature. No funds are included for new programs, tax policy revisions, or legislative initiatives.

Revenues

Revenues included in the 2009 biennium projections are estimated collections under state and federal law and accounting procedures, with the rates and allocation percentages as specified under current law. The projected revenues for FY 2007 through 2009 contained in this report are preliminary estimates, based on FY 2006 actual collections and current economic trends. These revenue projections will be subject to more in-depth analysis and refined later in calendar 2006, as the Revenue and Taxation Committee undertakes its statutory duty to prepare a revenue estimate for presentation to the 2007 legislature.

It should be noted that the complexity in estimating individual income taxes is especially difficult for this budget cycle. The most recent tax return data available for analysis is CY 2004. The CY 2005 data will not be available until early November.

In addition to dated data, another complexity involved in estimating individual income taxes is the implementation of the state tax reform legislation (SB 407) enacted by the 58th Legislature. The individual income tax provisions of this legislation are effective January 1, 2005 with a subsequent capital gains tax adjustment effective on January 1, 2007. Most of the state modifications can be incorporated into the simulation model. To the extent there are taxpayer behavioral changes, however, the model cannot be adjusted and less reliable methods must be used.

Expenditures

Actual expenditures in FY 2006 are used as the starting point for base expenditures. Actual expenditures, minus one-time-only expenditures, were doubled to provide a base from which present law increases were calculated.² The following additional general adjustments were made in projecting present law costs into the 2009 biennium:

- Personal services costs are at the level of FTE used to calculate 2007 biennium personal services costs by the 59th Legislature, with adjustments to reflect continuation of the 2007 biennium pay plan into the 2009 biennium
- Anticipated enrollment changes in K-12 and the university system have been included
- Caseload and entitlement adjustments in human services and corrections programs (including Medicaid and prison population) anticipated under present law are included
- Budget modifications and miscellaneous (“cat and dog”) appropriations enacted by the 59th Legislature are excluded if they were designated as one-time expenditures, while those funding ongoing duties are included in the present law projections
- Appropriations phased in during the 2007 biennium are funded for the entire 2009 biennium (e.g., pay plan)
- Vacancy savings is taken as a reduction from total personal services to reflect that, due to position vacancies and other personnel policies, less than full funding of personal services is sufficient to meet agency employment obligations. Historically, the legislature has implemented some form of vacancy savings, and the typical average vacancy savings rate adopted in legislative budgets in recent biennia is 4 percent (the percentage used in this projection)

² The same methodology is used in the general fund status sheet during the legislative session.